

As a department head in the hospital, you and your colleagues need to decide on w...



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Healthcare Finance- Owning vs. Leasing Hospital Equipment of the of the Healthcare Finance- Owning vs. Leasing Hospital Equipment

Introduction

Finance plays a very important role in business decisions. The resources of a business include men, materials and machinery but obviously the assets must either be provided for by the owners and operators of a business enterprise or financed through other means such as borrowing or leasing. Leasing can be thought of as an alternative to owning an asset. A lease is a contractual agreement in which the lessor (owner of the asset) gives the right to the lessee (user) to use that asset for a specified period of time. In this case we have to decide whether it would be more feasible to own a piece of equipment or lease it for a particular period of time.

Discussion

A decision whether to own or lease a particular piece of hospital equipment would have to take into account many factors. The most obvious is the cost of the equipment. In the given scenario, the cost to buy is \$75, 000.

Needless to say that this is a considerable sum of money to pay outright and therefore there is an alternative consideration at hand whether to lease the equipment for five years. The lease rental is \$ 11, 000 per year, for five years. Depreciation is one factor that needs to be considered as well as it would reduce the value of the equipment. Another factor would be revenues and number of people using that equipment.

In an operating lease, the lessor would bear the cost of reduction in the value of the asset, but in the case of a capital lease, this would be transferred to the lessee. A lease is considered to be a capital lease if (a) the terms of lease contain a bargain price option, (b) the lease term is equal to <https://assignbuster.com/as-a-department-head-in-the-hospital-you-and-your-colleagues-need-to-decide-on-whether-to-purchase-new-equipment/>

75% or more of the estimated useful life of the asset, (c) the present value of the minimum lease payments amount to 90% or more of the fair value of the leased asset, and (d) the lease transfers ownership of the asset to the user at the end of the lease term (Meigs & Meigs, 1993). We are told nothing about (a) or (d) but can calculate (b) and (c).

Let us start by assuming that we buy the equipment and that it is being fully depreciated on a five year life term. As per the data given, depreciation schedule will be as under:

Year	Depr Exp	Accum Depr	Book Value
1	Purchase Price	75,000	
2	Annual Depr- Year 1	0 075,000	
3	Annual Depr- Year 2	10,000	65,000
4	Annual Depr- Year 3	10,000	55,000
5	Annual Depr- Year 4	10,000	45,000

We are told nothing about the discount rate to use here to calculate the present value of the lease rentals. However if we assume a discount rate of 10 percent, the present value of the lease rentals will be as under:

Year	Rental Present Value @ 10%
1	$11,000/1.10 = 10,000.00$
2	$11,000/1.21 = 9,090.90$
3	$11,000/1.331 = 8,264.46$
4	$11,000/1.4641 = 7,513.14$
5	$11,000/1.61051 = 6,830.13$
Total Present Value of 5 Year Rental = \$41,698.63	

This calculated present value is more than 90 percent of the depreciated value of the equipment as at year 5. Ninety percent of the depreciated value <https://assignbuster.com/as-a-department-head-in-the-hospital-you-and-your-colleagues-need-to-decide-on-whether-to-purchase-new-equipment/>

of the equipment amounts to \$40, 500 in year 5. So it is definitely a Capital Lease.

In the current circumstances, it would be better to buy the equipment rather than to lease it. This is because the salvage value of the equipment at the end of the leased term stands at \$45, 000, compared to the \$41, 698 of the present value of the leased payments.

Conclusion

Leasing or owning equipment can be a major decision in a hospital environment. Comparing the net present value of inflows and outflows can be useful in taking a final decision.

References

Meigs, R. F. & Meigs, W. B. (1993): Accounting: the Basis for Business Decisions. McGraw Hill Publications.